UniCredit Group

8 November 2010

Holding: Institutional and Regulatory Strategic Advisory
UniCredit Bank Austria AG, UniCredit Bank AG, Bank Pekao S.A.

UniCredit Group's reply to the CEBS CP 42 on remuneration

GENERAL REMARKS

UniCredit welcomes the opportunity to participate in the Committee of European Banking Supervisors (CEBS) consultation on *Guidelines on Remuneration Policies and Practices* (CP42). We wish to make the following general remarks on the draft text:

- ***IMPLEMENTATION DATE:*** Member States are asked to **bring into force provisions effective from 2010 bonus payouts**, which disregards the fact that terms had already been agreed upon upfront and often defined contractually in early 2010 (as in UniCredit). We invite CEBS to set implementation for 2011 bonuses or, as a minimum change, to grant **supervisors flexibility to consider this critical issue when enforcing provisions**.
- ***GLOBAL CONSISTENCY***: We are concerned by the unremitting evolution of different international regulations, which create global inconsistencies across EU and non-EU jurisdictions alike. While we welcome CEBS guidance, we underline that provisions are applicable **only to the banking sector with potentially detrimental effects compared to other sectors of the market**. Likewise, within the banking industry there may be **differences in application both across main financial hubs** and in any given country. We invite CEBS to foster the progression toward global consistency by allowing EU supervisors and firms to more gradually move ahead considering also the progress of other jurisdictions and industries.
- ***FLEXIBILITY, PROPORTIONALITY AND PRESCRIPTION:*** The guidelines introduce further prescription on incentive design, restricting firms' ability to develop appropriate remuneration structures and increasing the complexity of compliance. Stringent interpretations are difficult to reconcile with varying compensation structures, thus leading to **distortion, rigidity and complexity with unintended systemic effects**. We are **particularly concerned about prescription in the pay mix due to the integration of the 40/60 deferral requirement with a 50% equity rule**. While the concept of proportionality is welcome, we are concerned that certain indications make it difficult for supervisors and institutions to deviate from stated standards. We invite CEBS to provide a guideline framework that strengthens outcome-focused principles while encompassing different approaches that meet underlying aims.

- ***SUPERVISORY ROLE AND MEMBER STATE IMPLEMENTATION:*** Since implementation depends on national provisions, we stress the importance of maintaining a **consistent level playing field** and are particularly worried that some Member States are already moving ahead. We see a risk of duplication and overlap in supervisory roles for the parent company and subsidiaries across States, and are in favour of cooperation to avoid the need to demonstrate compliance separately with each regulator. We expect supervisors to reconcile provisions with local frameworks impacting on feasibility and implications (eg. tax, labour laws). We invite CEBS to suggest Member States refrain from issuing provisions until the consultation is over.

SPECIFIC CONSIDERATIONS

INTRODUCTION

(3. Implementation date / paragraph 10)

Member States are asked to **bring into force provisions which are also effective to bonuses for the year 2010**. Retroactive implementation may well cause civil claims by employees against banks as the terms and conditions of bonuses to be paid out in 2011 had already been agreed upon upfront in 2010 and defined in contractual terms. Therefore, a clarification that the application of new guidelines on bonuses determined earlier than January 2011 are subject to "mutual agreement" would be helpful. Furthermore, specific actions to meet new requirements – such as share-based payment of a portion of upfront incentives – may proceed only with shareholder approval, which cannot be obtained in time for the bonus round.

We suggest CEBS avoids effectively back-dating the implementation date and establishes that provisions be applied starting from bonus payouts not yet defined as at the date of promulgation. We strongly advocate this approach as a feasible timeline which allows firms to adapt existing practices and take necessary approval steps (including via 2011 Annual Shareholders Meetings as needed). Should this not be feasible, as an alternative we suggest a minimum change that CEBS leaves some space for local legislators to take such cases into due consideration when enforcing provisions regarding the implementation date.

1. OUTLINES

(1.1.1. Which remuneration?)

We observe that retention bonuses are considered a form of variable remuneration and can be allowed to the extent that risk alignment requirements are properly applied (paragraph 14). We welcome this clarification, especially considering the risk of asymmetry with respect to hiring firms able to offer "sign-on" bonuses in the first year of hire (paragraph 12).

We suggest CEBS could further highlight as an example of proportionality/guideline that the design/use of retention bonuses is conceptually symmetrical to that of welcome/sign-on bonuses.

(1.1.3. Which staff? / paragraphs 15 - 16)

We appreciate the further guidelines on criteria for identified staff that allow each institution to define categories in a manner consistent with their organisation. We would be concerned if more specific prescriptive requirements – for example, on compensation thresholds - were to be issued by single Member States. Such an approach would limit proportionality and create a risk of differing standards. We note, for example, that the guidelines are slightly different from existing indications (Draft FSA Remuneration Code, Bank of Italy) and it would be helpful for there to be a consistent approach to the criteria for Identified Staff throughout Member States. We observe that not explicitly excluding low earners from the category of identified staff may create distortions in compensation practices since application of the specific requirements (deferral, equity) seems inappropriate and unnecessary in such cases. Because of the low probability that low earners are risk takers with considerable influence on the overall risk of the financial institution, it would avoid misunderstandings if they were excluded from the scope in the first place.

We suggest CEBS, in the interest of a level playing field, invites Member States to avoid a more prescriptive definition of risk-takers in individual jurisdictions. Moreover, it would be useful to clarify that employees materially impacting on risk profile insofar as they exert a *controlling function* over risks (eg. CRO) fall within the specific "control functions" category and NOT within the "other risk-takers" category. In this regard, the reference to "credit officers" may be misleading and could be reviewed (being also too broad and potentially covering all staff in the credit function).

We refer to the phrase "*any staff member, whose total remuneration would fall within that range, should be assessed. It is likely that in some cases, those staff members whose remuneration is as high as or higher than senior executives and risk takers will exert material influence on the institution's risk profile in some way. In other situations, this may not be the case*." This may be interpreted to mean that employees in the "**same remuneration bracket**" as executives and risk-takers should be "assessed" but not necessarily subject to the specific remuneration requirements.

We suggest CEBS clarify if, after carrying out the assessment, the employee is deemed NOT to exert material influence on risk profile, they should in any case be considered as subject to the specific requirements. Our recommendation would be to exclude high earners from the specific requirements if they demonstrably have no material risk impact, since the impact on risk-taking behaviours that underlies the remuneration principles becomes immaterial.

(1.2. Proportionality)

We agree that supervisors should ensure that the application of the **proportionality approach** preserves a level playing field among different institutions and jurisdictions. However, we are concerned that the actual space for a proportional application of the principles is severely limited by the more prescriptive standards that rather favour an increasingly rigid structure (paragraph 22).

By definition, proportionality implies case-by-case implementation and degree of standardisation; large institutions should be allowed to apply different judgment in designing specific incentive schemes for each business/division. A fee-for-service business (e.g. asset management) would require less risk adjustments to remuneration than businesses which are more heavily engaged in proprietary trading activities. Typically the asset management business mode is such that CRD requirements should not be applied: a) is an agency

business with no balance sheet risk; b) is subject to a pre-agreed mandate: c) client assets are segregated and held by an independent custodian; d) variable remuneration pool reflects real value that has been added to the business and captured for clients. Moreover the asset management divisions of large European banks might find themselves in a disadvantaged position in attracting and retaining talented resources compared to independent asset management firms in European and non-European jurisdictions (particularly in the USA and Asia).

We suggest, given the highly important and welcome concept of proportionality, it may be further stressed that supervisors will need to collaborate across jurisdictions to ensure a common understanding of proportionality, especially as it applies to a parent company overall in cases where subsidiaries are subject to different local supervisors.

"*…The Regulation shall only apply to significant institutions*" German regulators (Institutsvergütungsverordnung, 6/10/2010, Sec 1 para 2) chose total assets of institutions as indicators for the classification as "*significant institutions*" (bedeutendes Institut). An institution is significant if its total assets on average on the relevant reporting dates of the past three financial years closed reach or exceed €10bn and it establishes on its own responsibility on the basis of a risk analysis that it is significant. As a rule, institutions whose total assets reach or exceed €40bn on average as at the relevant reporting dates in the last three financial years ended are to be considered as significant (paragraph 24).

We suggest CEBS invite supervisory colleges to maintain common definitions of indicators to clarify the scope and guarantee an EU-wide consistent interpretation.

(1.3. Group Context)

We note that the need to "**take into account local regulations**" (paragraph 27) may in some points prove inconsistent with specific CEBS guidelines, for example, regarding severance (paragraph 70) and contractual renegotiation (paragraph 37).

We suggest that Member States be able to take due consideration of such aspects when enforcing provisions.

We observe that the guideline "each jurisdiction should consider applying the remuneration requirements to the staff if non-EA branches" leaves room for uneven application (paragraph 29)

We suggest this guideline be reformulated so as to further promote a **level playing field**.

(1.4.2. Capital base)

Institutions are invited to ensure that they **adapt their contractual agreements** (paragraph 37) with staff members in order to ensure that they do not limit their ability to comply with these requirements. We observe that this may be problematic, particularly with reference to (paragraph 27) on local legislation and (paragraph 10) implementation date, and is in any case subject to mutual agreement between the parties.

We suggest this guideline be reformulated so as to allow national supervisors to cater to local constraints.

2. GOVERNANCE OF REMUNERATION

(2.3. Control functions)

We are of the opinion that **control functions** should be involved in high level principles, but not in the micro-design of incentive schemes and, even less so, in setting amounts (paragraph 58).

We suggest to review the guideline whereby the recommended role of control functions includes involvement in "setting individual remuneration awards". The involvement of control functions in this specific activity would typically be limited to the HR function (considered by CEBS to be a control function, different from most national approaches and organisational models).

We refer to the phrase "If remuneration of the control functions includes a component based on institution-wide performance criteria, the risk of conflicts of interest could be increased and, therefore, should be properly addressed" (paragraphs 60 - 62). We would interpret this as meaning that an overall alignment between the affordability of reward levels (measured via institution-wide mechanisms such as "company factor" or adjustments on a dedicated bonus pool), including control functions, is consistent with the principles as long as the overall incentive framework is demonstrably consistent with a sound approach.

We suggest that this indication be further reinforced as we are in favour of ensuring that incentives for control functions be designed in such a way as to avoid conflict of interest while remaining affordable and aligned with a company's ability and willingness to offer incentives.

We note some difference in the definition adopted of **control functions** (paragraph 16 vs paragraph 57) respectively as "finance control" and "the CFO to the extent that he/she is responsible for the veracity of the financial statements".

We suggest it may be useful to clarify that "finance" is considered as a control function insofar as the role is responsible for signing the balance sheet or financial statements.

3. GENERAL REQUIREMENTS ON RISK ALIGNMENT

(3.2.1. Guaranteed variable remuneration / paragraph 69)

We note that guarantees are only allowed for external hires in the first year and observe that this could be interpreted as meaning that an overall amount defined as a sign-on bonus should be payable entirely upfront.

We suggest CEBS clarify that it may also be appropriate to pay a guaranteed sign-on bonus to new hires pro-rata over more than one year (ie. to maintain lost cash-flow from the previous employer, without applying claw-back conditions).

(3.2.2. Severance pay / paragraphs 70 - 71)

Severance arrangements, including payments in lieu of notice and link to seniority, are often prescribed or suggested by local labour law or collective agreements and may be incompatible with a single EU standard or limit. While we appreciate that the 24 month fixed

remuneration as maximum amount is a suggestion that firms should "pay due regard" to, this creates an external stakeholder expectation which firms must then struggle to reconcile with existing binding legislation.

We suggest that CEBS invites supervisors in their implementation provisions to ensure that severance payments remain in line with applicable standards within the context of specific local constraints. We would invite CEBS and supervisory colleges to specifically foster alignment in local legislation.

We observe that the term "golden parachute" seems to encompass a broad and somewhat vague concept, not limited to change of control conditions or specific characteristics but rather any termination payment perceived as "large".

We suggest clarifying what features distinguish a "golden parachute" from standard severance arrangements.

4. SPECIFIC REQUIREMENTS ON RISK ALIGNMENT

(4.1. Fixed versus variable remuneration)
(4.4. Payout process)

We are particularly concerned about the combined interpretation of **cash vs equity** and upfront vs deferred requirements, which is more prescriptive than is required under the FSB remuneration principles. In line with the principle of proportionality and in the interests of a flexible remuneration policy able to maintain alignment with business and people strategy as well as sound risk management, firms should be permitted to consider their own risk profile and determine appropriate schemes. We suggest in particular that the CEBS interpretation of a combined equity/upfront rule be brought back in line with the FSB interpretation whereby 50% of the overall variable compensation be payable in equity, without further prescribing this requirement separately on the upfront and deferred components. Since the most appropriate ratio of cash and equity may be influenced by differing conditions and characteristics of upfront vs deferred payouts, we believe that firms should have appropriate flexibility to determine how equity is used (with appropriate levels of deferral and/or retention to meet requirements and be aligned properly with risk).

We suggest that the proportion to be paid in shares or share-related vehicles be applied to the total variable compensation and not the upfront payment separately from the deferred payment; this would accomplish the major objective of requiring a substantial variable compensation payment in equity without unduly over-complicating the structure of the incentives.

Beyond this most critical issue regarding such a combined interpretation, CEBS also uses the phrase "institutions must apply the same chosen ratio between instruments and cash for their total variable remuneration to both the upfront and deferred part" (paragraph 130). We are of the opinion that this wording is misleading and the intention is not to say, for example, that it is an "incorrect practice" to pay 50% of upfront incentives in equity and 60% of deferred incentives in equity.

We suggest clarifying that the intention is to maintain at least 50% of variable compensation in equity – not necessarily the exact same ratio applied separately for upfront vs deferred parts.

We would also comment that the prohibition of an upside on deferrals and long term incentives seems an unnecessary restriction with unclear rationale in terms of risk-taking implications. The major point of aligning deferrals with the time horizon of risk is to reconcile payouts with actual realised performance over time, which could be positive or negative; forward-looking long-term incentives are intended to motivate excellent performance over a multi-year period to achieve strategic objectives aligned with shareholder interests (paragraphs 141).

We suggest maintaining the option to include upside opportunity on forward-looking long-term incentives within a reasonable range.

We also note that the use of equity or share-based instruments is, in any case, subject to shareholder approval and there is a risk of creating a situation whereby shareholder interests, for example in terms of dilution or preferred incentive vehicles, may not be in agreement with the strict equity provisions. For smaller financial institutions and for employees where bonus payments are relatively low, the burden of issuing and monitoring financial instruments might be overly high. It might be an acceptable alternative to link this requirement to the profitability of the financial institution using other performance indicators which are agreed with the local regulator. The German legislator chose a similar solution: Insituts-Vergütungsverordnung, 6/10/2010, Sec 5 para 2 , sub-para 5: 50% of the upfront part and 50% of the deferred part shall depend on the sustainable value development of the institute…. (=von einer nachhaltigen Wertentwicklung des Instituts abhängen.) Similar approaches adopted only in some Member States risks creating significant inconsistencies.

We suggest the use of equity be framed with adequate flexibility to cater to shareholder interests and business strategy whereby the principle of proportionality is key to determining appropriate use within an overall sound remuneration practice, ensuring sound risk management. For asset management businesses, it has been market practice for many firms to have some part of the variable pay in their own managed funds, which closely aligns fund managers with their investors. Where variable pay is linked to managed assets, we suggest it should be regarded as "equity/equity like" for the purposes of the guidelines.

The proposed application of retention policies for equity (paragraph 125), especially in conjunction with other recommended practices such as deferral and multi-year performance conditions which already form the basis for a solid risk-aligned approach, may become excessively rigid and may, in fact, cause compensation levels to increase due to less value being perceived by employees.

We suggest clarifying that the principle of proportionality is key in determining whether rewards determined within sound remuneration practices built on rigorous performance measures and appropriate deferral should be further subject to additional retention policies. We would also suggest that the guideline for determining an appropriate retention period should be aligned with the time horizon of the risk rather than the materiality of that risk.

Regarding the use of "contingent capital" (paragraph 121), we observe there is a significant lack of clarity and precedent on their application, an unclear market for such "hybrid instruments" and uncertain administration implications.

We suggest that existing CEBS guidelines on hybrid instruments be further elaborated to clarify their use as a vehicle for incentive payouts and to provide examples of what is considered "appropriate and applicable" and under what circumstances shares or equivalent should be "combined" with contingent capital.

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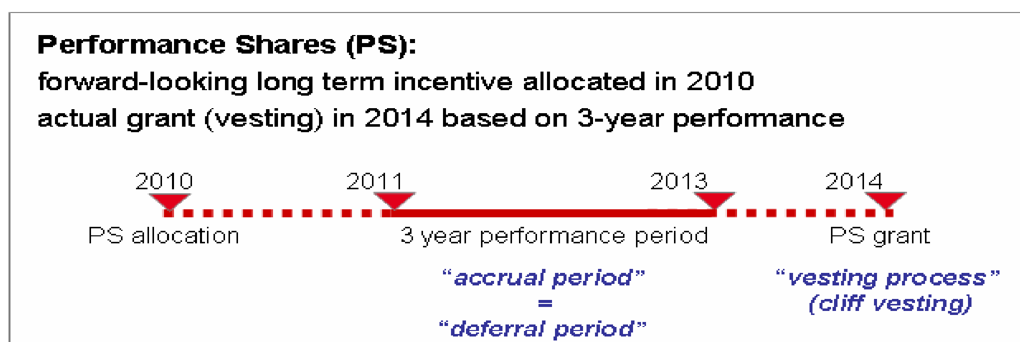
We appreciate clarifications on aspects of the reward and payout process. However, we observe that the definitions of **"accrual period", "vesting period" and "deferral period"** are not compatible with some widespread practices that are demonstrably aligned with sound risk management. For example, stand-alone long term incentives may take the form of performance shares whereby the "accrual period" over which performance is evaluated corresponds to the "vesting period" and, in the case of cliff vesting, to the deferral period (paragraphs 116 - 120).

Example of common performance shares practice



We suggest that the guidelines be formulated in such a way as to accommodate different remuneration practices that comply with underlying principles via differing mechanisms.

(4.2. Risk alignment of variable remuneration - paragraphs 91; 95 - 97)

We note the distinction made between **"quantitative" and "qualitative"** criteria to assess performance. We wish to point out that we consider quantitative criteria as those measurable via a quantifiable KPI and therefore not solely financial but also other performance drivers measured via quantitative criteria but cited in the guidelines as "qualitative"– eg. customer satisfaction, people engagement, reputation, etc. We note also that Total Shareholders Return (TSR) is cited as a short-term measure not adjusted for risk and we would like to highlight that its use as a performance condition in long-term incentive plans may still be an appropriate way to align rewards to shareholder interests, when effectively balanced with complementary risk-adjusted measures.

We suggest clarifying the distinction between quantitative (measurable metrics) and qualitative (primarily relying on discretional elements as the basis for judgement). While guidelines on the use of specific indicators may be useful as examples, judgement on the adequacy of performance measures should be, in any case, made within the overall context of the incentive system design and characteristics.

We note that reference to **relative external measures** is primarily to market measures (eg TSR, share price) and would clarify that external metrics may also be used as an approach to measure operational performance and sustainable value creation via benchmarking and ranking versus market peers on a broad range of financial and non-financial measure (paragraphs 98 - 99).

We suggest CEBS takes into consideration that "market" indicators are not the only parameters used in evaluating relative performance, since comments on strengths and weaknesses are currently misleading.

The requirement that 50% of non-deferred variable compensation be paid in equity instruments and retained for a period of time triggers immediate tax consequences in most Member States, subsequently turning an individual's bonus into a tax liability.

We suggest that CEBS considers removing the requirement for a retention period or, if this is not possible, then the sale of sufficient shares to meet the upfront tax liability should be permitted in order to avoid unequal and disadvantageous tax liabilities.

5. DISCLOSURE

(5.1. External disclosure)

In relation to disclosure and any further guidance given on the disclosure requirements, it is important that agreement is reached between regulators in different countries with respect to general remuneration disclosures, so that disclosure in the home country can be sufficient to meet the requirements in all the countries in which a firm operates. We are concerned that differences in the level of disclosure required will lead to competitive disadvantage and would argue that the information disclosed be standardised for all firms subject to the guidelines.

We suggest CEBS clarify to supervisors that, if jurisdictions decide to require disclosure, not only at consolidated level but also for "significant subsidiaries", they should ensure this, in any case, takes due consideration of the parent company disclosure, is consistent with proportionality as expressed by the parent company and reviewed by the relevant home company regulator, and in no case differs in the disclosure required across jurisdictions.

We welcome any guidelines to promote transparency. Although disclosure of individual compensation data is not explicitly required, we recommend that "disclosure" should not be extended to individual compensation data for every employee included in each category identified (e.g. risk takers, senior executives, high earners).

We suggest that CEBS invites supervisors to maintain a consistent approach in any more prescriptive requirements issued locally. Individual disclosure should, in any case, be limited to very few employees since we should not underestimate the impact in such terms as social conflict, excessive media exposure, the inflationary impact on compensation levels or potential criminal action which might undermine individual security.

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Holding Company contact people:

Heads of Departments
Giovanni Lanati, Compensation in Human Resources (HR-C)
Sergio Lugaresi, Regulatory Affairs (RA)
Guido Moscon, Banking Supervisory Relations (BSR)
Giuseppe Silvestro, Compliance Monitoring and Reporting (CMR)
Philipp Waldstein, Group strategic funding and portfolio (GSF&P), Group Finance
Ermanno Bonessi, Corporate law advise (CLA)
Maurizio Francescatti, Group Risk Management Operating Office (GRM)
Simone Concetti, Investor Relations (IR)

CEBS contact:
Marco Laganà, RA, Marco.Lagana@unicredit.eu

Human Resources - Compensation
Sian Carson, *coordinator*
Mariangela De Matteo

Involved experts
Federico Ravera, GSF&P, Group Finance
Darbari Abhishek, GRMO
Puricelli Massimo, CMR
Manlio Stefano Nuzzo, CLA
Andrea Cremonino, BSR
Laura Spotorno, IR
Simone Martina, HR Asset Management
Phil Curtis, HR Corporate Investment Banking

Group Organization
Andrea Mantovani, Processes and CL Support

UniCredit Bank Austria AG,
Margit Schmid-Weihs, Compliance